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In the Supreme Court of the United States

OCTOBER TERM, 1958

No. ——

SECURITIES AND EXCHANGE COMMISSION, PETITIONER

v.

INSURANCE SECURITIES INCORPORATED, TRUST FUND SPONSORED BY INSURANCE SECURITIES INCORPORATED, ABE P. LEACH, OSSIAN E. CARR, ARTHUR J. LONERGAN, ROY A. HAIGHT, AND LELAND M. KAISER

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

The Solicitor General, on behalf of the Securities and Exchange Commission, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit, entered in the above-entitled case on April 7, 1958.

OPINIONS BELOW

The opinion of the District Court (R. 142–150)[1] is reported at 146 F. Supp. 778. The opinion of the Court of Appeals (App. A, *infra*, pp. 22–40) is not yet officially reported.

[1] Record references are to the printed record in the court below, nine copies of which have been filed with this Court.

JURISDICTION

The judgment of the Court of Appeals was entered on April 7, 1958 (App. A, *infra*, pp. 40–41). The jurisdiction of this Court is invoked under 28 U. S. C. 1254 (1).

QUESTION PRESENTED

Whether a sale of control of a management company, which, pursuant to contracts, serves as investment adviser and principal underwriter for an investment trust, constitutes a "gross abuse of trust" under Section 36 of the Investment Company Act of 1940 where the sales price includes payment for its fiduciary position with respect to the investment trust and for the opportunity to secure the succession to the contracts, which, because of their fiduciary character, are nonassignable under the Act.

STATUTE INVOLVED

Pertinent provisions of the Investment Company Act of 1940, 54 Stat. 789, 15 U. S. C. 80a–1, *et seq.*, are set forth in Appendix B, *infra*, pp. 42–47.

Section 36 of the Investment Company Act, the application of which is directly involved, provides:

INJUNCTIONS AGAINST GROSS ABUSE

> SEC. 36. The Commission is authorized to bring an action in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after the enactment of this title and within five years of

the commencement of the action, of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts:

(1) as officer, director, member of an advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate.

STATEMENT

The Securities and Exchange Commission filed its amended complaint on August 13, 1956, in the United States District Court for the Northern District of California pursuant to Section 36 of the Investment Company Act of 1940 ("the Act"), *supra*, p. 2, and other provisions thereof (R. 3–48). Section 36 authorizes the Commission to seek an injunction to restrain any person from acting as a director, officer, or investment adviser for any registered investment company, or as principal underwriter for any open-end[2] registered investment company, and in other specified capacities, by reason of "gross misconduct

[2] Under Section 5 (a) (1) of the Act, App. B, *infra*, p. 45, an "open-end" company is a company which is offering for sale or has outstanding any security redeemable on demand of the security holder. The investment company in the instant case is an open-end company.

or gross abuse of trust" with respect to such investment company. The Court of Appeals affirmed the judgment of the District Court dismissing the Commission's amended complaint for failure to state a cause of action.

The registered investment company in this case is the Trust Fund, created in 1938 pursuant to California law under the sponsorship of Insurance Securities Incorporated ("ISI") (referred to by the court below as "service company"), a California corporation organized in the same year (R. 4, 5). Until shortly after the filing of the complaint, as noted below, the Trust Fund, like many other funds, had no board of directors of its own (R. 6; App. A, p. 25). ISI has been sponsor, manager and investment adviser of the Trust Fund, as well as its principal underwriter (R. 6, 24; App. A, p. 24). ISI has no other business (R. 5).

As investment adviser, ISI has been managing and directing the portfolio investments of the Trust Fund. As principal underwriter, ISI has been offering to the investing public Participation Agreements, from the continuous sale of which the Trust Fund derives its capital funds for investment in stocks of various insurance companies (R. 5, 6, 32–33; App. A, p. 25). As of December 31, 1955, net assets of the Trust Fund were about $215,000,000 (R. 5–6).

ISI receives a "creation fee", or sales load, for the sale of Participation Agreements on behalf of the Trust Fund, in addition to annual management and advisory fees. ISI has no other source of income. For the three-year period prior to the filing of the Commission's complaint ISI's fees were (R. 6):

	1953	1954	1955
Creation fees	$1,847,948	$2,990,222	$4,354,300
Administrative fees	165,432	224,452	276,724
Advisory fees	97,687	134,009	166,357
Other	710	884	1,126
Total	2,111,777	3,349,567	4,798,507

The investment advisory and principal underwriting services have been rendered, as required by Section 15 of the Act, App. B, *infra,* pp. 45–47, pursuant to written agreements between ISI and the Trust Fund. These agreements are not assignable and are automatically terminated in the event of their "assignment by the investment adviser" or "by such underwriter" (R. 6–7). See Sections 15 (a) (4) and 15 (b) (2). The term "assignment" is broadly defined in Section 2 (a) (4) (Appendix B, *infra,* p. 43), so that the sale of stock control of ISI constitutes an assignment of the underlying contracts.[3] Under Section 15 of the Act, new investment advisory and underwriting agreements required approval by a majority vote of investors of the Trust Fund.

As of January 1, 1956, and for some years prior thereto, 72.6% of the capital stock of ISI was held by Abe P. Leach, Ossian E. Carr, Arthur J. Lonergan and Roy A. Haight, individual defendants in this case, and the balance by five other persons (R. 7–8). The individual defendants also have been directors of ISI since 1938, members of its executive committee, and its officers (R. 4).

[3] Section 2 (a) (4) defines an "assignment" as including "* * * any direct or indirect transfer * * * of a contract * * * by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor."

The Commission's complaint alleges that on or about February 1, 1956, the individual defendants, acting alone or in concert with others, "embarked upon a plan to sell their stock interests in ISI to a small number of purchasers affiliated among each other through stock ownership and otherwise" (R. 8). The sales were effected in stages between February and July 1956 (R. 8). The total sold amounted to 53% of the shares outstanding, at $50 per share.[4] Net book or asset value was $1.81 per share and the aggregate price for the shares was about $4,240,000 in excess of their net book value (R. 9, 16–17). Of the total shares thus sold, 68,000, or 40.8%, were supplied by the individual defendants, the remainder by four other stockholders (R. 9).

Shortly after these stock transactions, ISI commenced to solicit proxies for a special meeting of investors in the Trust Fund scheduled for August 15, 1956. The cost of the solicitation was paid by ISI (R. 12, 21). Among other things, the purpose of the solicitation was to secure a favorable vote of investors on new investment advisory and principal underwriting contracts (R. 23–32, 42, 44, 46), the prior contracts, as alleged in the complaint (R. 11), having been terminated by the sale of control of ISI.[5] The

[4] The purchasers were: three companies controlled by Murchison Bros., Dallas, Texas, 30,000 shares; D. D. Harrington, Amarillo, Texas, 37,000 shares; Richardson & Bass, Fort Worth, Texas, 21,000 shares (R. 56–59).

[5] In ISI's proxy material it is stated that the "change in majority ownership may be considered an assignment" of the contracts (R. 33). It was urged below that there was no sale of control. The district court said this was an issue of fact

proxy material, as alleged in the amended complaint, did not disclose (among other things) the price the ISI directors received for their stock, the net asset value of the stock, or the aggregate financial gains these directors obtained as a consequence of the sale of control (R. 13, 47). In addition, ISI submitted to investors a proposal to establish for the Trust Fund a board of directors to consist of seven members. The nominees were selected by ISI; all were directors of ISI, although upon their election four resigned from the ISI board of directors (R. 24–25, 142). Among the seven members is Leland M. Kaiser, who had previously become president and a director of ISI, and through whose firm the sale of the ISI stock had been arranged.

The substance of the Commission's action, as alleged in the amended complaint (R. 9–10), is that the price o $50 per share, or 25 times its net asset value, did "not represent the real and actual value" of the ISI stock or payment "for any asset or assets owned" by ISI. The unique and substantial "asset", for which the purchasers paid about $4,000,000, was stated to be the opportunity to succeed to ISI's contractual and fiduciary arrangements with the Trust Fund. These arrangements, being non-assignable, were not disposable assets of ISI or of its management; and, as

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not subject to determination "on a motion to dismiss or even on a motion for summary judgment" (R. 160), and in dismissing the complaint based its decision on the assumption that there was a sale of stock control as alleged in the complaint (R. 146–147). This was also the assumption of the Court of Appeals (App. A, p. 32, fn. 9).

fiduciaries, the directors of ISI, like ISI itself, could not profit, either directly or in the form of a premium on their stock, by surrendering their management position in favor of successor interests. For these reasons the Commission sought an injunction restraining the individual defendants from serving as members of the proposed new board of directors for the Trust Fund[6] and restraining ISI from serving as the Trust Fund's investment adviser or principal underwriter. The Commission also sought an accounting and other relief (R. 14–15, 47–48).

The District Court granted defendant's motion to dismiss the amended complaint for failure to state a claim for relief (R. 151–152), and the Court of Appeals affirmed (App. A, p. 40). For reasons which we discuss later, the court below held, as did the District Court, that the acts alleged did not constitute a breach of trust under Section 36. In thus disposing of the basic question in the case, the District Court and the Court of Appeals did not decide the other issues raised regarding the applicability of Section 36, nor the merits of the second cause of action.[7]

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[6] Under an order of the District Court, entered upon consent, the individual defendants were restrained from serving as directors of the Trust Fund, pending a final decision in the case (R. 93–94).

[7] The court below assumed, for purposes of the motion, that ISI and the individual defendants were persons subject to Section 36 (App. A, p. 32); the District Court had indicated that, if the transaction involved a breach of trust, Section 36 was applicable to these defendants (R. 157–158).

The second cause of action alleged violations of the Commission's proxy rules in connection with ISI's solicitation of proxies for a vote of investors on ISI's proposed new agree-

1. This case involves a question of substantial importance in the administration of the Investment Company Act. In Section 36, Congress has authorized the Securities and Exchange Commission to seek an injunction to restrain an officer, director, investment adviser or principal underwriter of a registered investment company guilty of "gross abuse of trust" with respect to such company from serving in these and other fiduciary positions. Section 36 is designed to restore and to render more effective the fiduciary responsibilities of management of investment companies which have been aptly described as being "in essence institutions for the investment of the savings of small investors * * *"[8] Without effective regulation on this subject, as the Committee Reports said, "individuals who lack integrity will continue to be attracted by the opportunity available for personal profit in the control of the liquid assets of investment trusts and investment companies."[9] This is

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ments with the Trust Fund (R. 11–14). This action was dependent upon the first cause of action under Section 36 (R. 11, 150; App. A, p. 40).

By order dated August 14, 1956, entered on consent, the District Court had enjoined the voting of the proxies, pending a hearing on the Commission's motion for a preliminary injunction (R. 48–49). Subsequently, this order was dissolved by consent and the proxies were allowed to be voted upon the specific condition that this was "without prejudice to the power and jurisdiction of the Court to grant any and all relief" with respect to the vote if it is finally determined that the proxy rules had been violated (R. 94–95).

[8] H. Rep. 2639 on H. R. 10065, 76th Cong., 3d Sess. (1940) 6.

[9] H. Rep. 2639 on H. R. 10065, 76th Cong., 3d Sess. (1940) 8; S. Rep. 1775 on S. 4108, 76th Cong., 3d Sess. (1940) 6.

one of the main themes of the Act, since, as Congress found, investment companies, by reason of their liquidity and the marketability of their portfolio securities, had been particularly susceptible of abuse, *Aldred Investment Trust* v. *S. E. C.*, 151 F. 2d 254, 260 (C. A. 1), certiorari denied, 326 U. S. 795.

While, as noted below, the Act contains specific provisions intended to prevent over-reaching or self-dealing by those who manage or control investment companies, it was not intended that a narrow and stinted construction be given to Section 36. Since Congress could not proscribe in detail every means and stratagem by which a fiduciary might seek to exploit his position of trust, a broad conception of fiduciary obligations was clearly essential, and Section 36 fulfills that purpose. For Section 36 "invokes the equity power of the Federal Court * * *," *Aldred Investment Trust* v. *S. E. C.*, 151 F. 2d 254, 261 (C. A. 1), certiorari denied, 326 U. S. 795, and the very words "gross abuse of trust" connote fiduciary restraints and obligations. Accordingly, in enforcing Section 36, the court, as a court of equity, should apply historic equitable principles to their fullest extent and thereby give due and proper effect to the statutory measures and policies which Section 36 was designed to implement. Section 1 (b) of the Act specifically states that all of its provisions should be interpreted in accordance with "the policy and purposes" thereof. See also *S. E. C.* v. *Joiner Leasing Corp.*, 320 U. S. 344, 351–352.

2. The Commission's interpretation of Section 36 in the instant case simply involves the application of

the well-established doctrine, discussed *infra,* that a fiduciary, though he may resign from his position at will, commits a breach of trust if he accepts payment, directly or indirectly, from anyone who wishes to succeed him. ISI has no proprietary claim to its contractual arrangements with the Trust Fund. While ISI may receive payment for the services it renders under its agreements with the Trust Fund, the agreements themselves, as fiduciary undertakings, cannot be sold or assigned to another. Section 15 expressly prohibits the sale or assignment, and further provides that these agreements are automatically terminated upon "assignment," which, as defined in Section 2 (a) (4), includes the sale of stock control of ISI. Nor, as fiduciaries, may ISI or its directors and officers accept payment for the surrender of these fiduciary arrangements with the Trust Fund and for their strategic positions to influence or dictate the course of succession to new agreements.

It is this fundamental principle of equity that was violated in the instant case. For, as alleged in the amended complaint (R. 9–11), the price of $50 per share for stock control of ISI, as against net asset value of $1.81 per share, did not represent payment for any transferable asset of ISI. The price included a substantial premium aggregating about $4,000,000 which the purchasers paid because ISI and its directors and officers, though unable under the Act to assign the existing agreements, were strategically situated, as managers of the Trust Fund, to secure new agreements with the Trust Fund for the benefit of the purchasers.

The court below agreed that "the fiduciary relationship which the service company [ISI], including its directors and leading stockholders, occupied with regard to the Trust Fund arose by virtue of the service contracts" (App. A., p. 36). It also agreed that "it is no doubt realistic to attribute a large part of the value of the service company [ISI] stock to the contract which it has with [the] Trust Fund" (App. A., p. 37). It further agreed that "a person occupying a fiduciary relationship with another will not be permitted to exploit such relationship for personal gain * * *" (App. A., p. 37). It held, however, that no fiduciary principle was violated because (a) the price for the stock "did not come from the coffers of the investment company [Trust Fund], but from outside purchasers" (App. A, p. 38); (b) the evil lay not in the price for the succession but in the inequitable practices engaged in by those who had acquired management contracts at exorbitant prices and the practices "are effectively dealt with in many sections of the act" (App. A, pp. 38–39, fn. 15); and (c) investor approval or rejection of new agreements under Section 15 was the only remedy which Congress provided and deemed adequate (App. A, p. 39). These positions have no merit.

(*a*). In the first place, the court below construed too narrowly the applicable principle. A fiduciary violates his trust by accepting money for relinquishing his position in favor of a successor, even if the price for the succession does not come from the corpus of the trust. It was so held with respect to a personal trustee, *Sugden* v. *Crossland*, 3 Sma. & Giff. 192, 65

Eng. Rep. 620 (1856), as well as a corporate fiduciary, *Forbes* v. *McDonald,* 54 Cal. 98.[10] It is also applicable when payment for the succession to management was included in the form of a premium on the purchase of stock control. *Porter* v. *Healy,* 244 Pa. 427; *Benson* v. *Braun,* 286 App. Div. 1098 (2d Dep't);[11] *Perlman* v. *Feldmann,* 219 F. 2d 173 (C. A. 2), certiorari denied, 349 U. S. 952. In the *Perlman* case, a controlling block of shares of Newport Steel Corporation was sold by the president and chairman of the board and members of his family at $20 per share. On sale of the stock, all members of the board of directors resigned and the nominees of the purchasers were elected in their stead. Although no damage to the corporation was shown, the court held the defendants, as fiduciaries, liable for that portion of the purchase price which represented a premium for the power to control the distribution of the corporate product. The court said (219 F. 2d at 176) that under equitable principles "the responsibility of the fiduciary is not limited to a proper regard for the tangible balance sheet assets of the corporation, but includes the dedi-

[10] See also *McClure* v. *Law,* 161 N. Y. 78; *Moulton* v. *Field,* 179 Fed. 673, 675 (C. A. 7); 1 Perry, *Trusts and Trustees* 712 (7th ed. 1929); 3 Cook, *Corporations* 2428 (1923).

[11] In the *Benson* case, the court sustained the sufficiency of a complaint which alleged that fiduciaries had sold control by the sale of stock at a price far in excess of its fair value "on the theory that the said excess was paid for the resignations, for the election of the purchasers' nominees, and for immediate control of the corporation." On remand, the court, after trial, held that the plaintiffs had not proved the allegations in the complaint, *Benson* v. *Braun,* 155 N. Y. S. 2d 622 (Sup. Ct.).

cation of his uncorrupted business judgment for the sole benefit of the corporation, in any dealings which may adversely affect it." [12]

The same equitable doctrine was applied by this Court in *Young* v. *Higbee Co.*, 324 U. S. 204. Two stockholders, who were not directors or officers, nor dominant shareholders, of a debtor corporation in reorganization under Chapter X of the Bankruptcy Act, had appealed from an order confirming a plan of reorganization. During the pendency of the appeal, two purchasers, with their own funds, paid $115,000 for the stock of the dissatisfied stockholders, which had a market value of $17,000, on condition that the appeal be dismissed. This Court held that, having appealed on a matter which concerned the entire class of stockholders, appellants had assumed a fiduciary position which they could not thereafter surrender or exploit for their personal gain. See also *Clarke* v. *Greenberg*, 296 N. Y. 146, 71 N. E. 2d 443 (1947).

(*b*). In the lower court's view, the price paid for succession to management contracts was "but a symptom of the evil." The real evil, the court states, lay in "the inequitable practices" in which successors engaged upon their assumption of office or control. Accordingly, the court concludes that the inequitable

[12] It may be noted that Judge Swan dissented because he felt bound by the district court's findings that, as a control block, the stock of Newport Steel was worth $20 per share and that there was no evidence as to its value "if shorn of its appurtenant power to control distribution of the corporate product" (219 F. 2d at 179–180, fn. 1).

On remand, the district court held the defendants liable for $1.3 million, *Perlman* v. *Feldmann*, 154 F. Supp. 436 (D. Conn.).

practices "are effectively dealt with in many other sections of the act", and that "the value which such contracts may have today does not result from these outlawed or regulated practices, but from the normal factors determinative of the selling price of any corporate stock" (App. A, p. 39, fn. 15).

The simple answer is that such was not the solution that Congress deemed adequate and effective for one of the major abuses disclosed in the investigation.[13] There are of course other provisions in the Act, which the court does not specify,[14] designed to prevent overreaching by management and those affiliated with it, and such provisions do have deterrent effects against certain financial abuses. But to deal most effectively with the major problem of trafficking in management contracts, Congress also imposed specific restraints and sanctions upon the incumbents. Section 15 explicitly declares that existing contracts are not assign-

[13] The matter of trading in management contracts and other related aspects of the problem are documented in detail in SEC Report on Investment Trusts and Investment Companies, Part III, *Abuses and Deficiencies in the Organization and Operation of Investment Trusts and Investment Companies*, pp. 89–101, 1029–1031, 1078–1094, 1278–1303, 1363–1366, 1874–1888, 1918–1936, 2765–2768.

The Commission's investigation was made pursuant to Section 30 of the Public Utility Holding Company Act of 1935, 49 Stat. 837, 15 U. S. C. 79z–4. The Commission's Report, of which the foregoing is a part, was filed with the Congress (House Doc. No. 279, 76th Cong., 1st Sess.) and provides substantial legislative background for the Investment Company Act of 1940.

[14] We assume that the reference is to many provisions which the Commission discussed in its brief below, such as Sections 9, 10, 17, 25.

able and are automatically terminated upon such assignment, while under historic equitable doctrines embodied in Section 36, as the cases previously discussed demonstrate, a fiduciary is forbidden to traffic in the succession to his office at any price. In the context of a regulatory statute, these equitable doctrines are invested with a paramount public interest and should be broadly applied, *Virginian Ry.* v. *System Federation No. 40,* 300 U. S. 515, 552.

Management controls and prerogatives are powers in trust and are not to be bought and sold as the personal effects of the individual managers. Such practices inherently involve a conflict of interest, the full consequences of which can never be ascertained, *Woods* v. *City National Bank & Trust Co.,* 312 U. S. 262, 268. For the interest of the incumbents is in the best price and in the maximum financial gain to themselves, rather than in securing successors most qualified to assume the fiduciary responsibilities. If, as in the instant case, purchasers were willing to spend $4,000,000 of their anticipated future fees for the opportunity to secure the management contracts, those in control may not appropriate that opportunity for themselves. The appropriation of that financial advantage for their own benefit did "not betoken the necessary undivided loyalty owed by the fiduciary to his principal," *Perlman* v. *Feldmann, supra,* 219 F. 2d at 176. That in a particular case the successors in interest may not actually abuse their fiduciary position is immaterial. The Act, like many principles of equity, was designed to eliminate "not only actual evil results but their tendency to evil in other

cases", *Weil* v. *Neary,* 278 U. S. 160, 173,[15] and to prevent the existing abuses from again becoming a reality, *North American Co.* v. *S. E. C.,* 327 U. S. 686, 710–711.

(*c*). Finally, the court below holds that fiduciary standards and the sanctions under Section 36 were not applicable because Congress had specifically provided a single built-in remedy for this problem. The court refers to Section 1 (b) (6) (App. A., p. 43) which declares that the public interest and the interest of investors are adversely affected "when investment companies are reorganized, become inactive, or change the character of their business, *or when the control or management thereof is transferred, without the consent of their security holders;*" (court's italics). From this general declaration of policy the court infers that only the absence of investor consent to the succession—regardless of the price or circumstances—was the concern of Congress, and that the complete answer was given in Section 15 requiring investor consent (App. A, p. 45). No breach of trust, the court concludes, can be involved, for if "a service contract which has been automatically terminated" under Section 15 "can be reinstated by a vote of the investors * * * it ought not to be subject to injunctive restraint under § 36" (App. A., pp. 34–35, fn. 12).

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[15] In a recent case under Section 36, now awaiting trial, *S. E. C.* v. *Cryan,* S. D. N. Y., Civil Action No. 131–57, the complaint alleges that substantial sums were paid for the succession to management by persons for the alleged purpose of looting the investment company.

It should be noted that, regardless of the literal reading of Section 1 (b) (6), under Sections 15 (a) (4) and 15 (b) (2) existing advisory and underwriting agreements cannot be assigned, with or without approval of investors. Nor in casting their vote under Section 15 are investors called upon to approve or disapprove the sale of stock control of the management company, or to extenuate or condemn any wrongful conduct in which those who sold control may have engaged. When existing agreements are terminated, they vote only on whether to enter into new agreements with a proposed successor or successors. Succession to these agreements poses two distinct, though related, problems: (1) the manner in which, and by whom, the successor shall be selected; and (2) the fiduciary obligation of the existing management when relinquishing control either voluntarily or by operation of law.

In Section 1 (b) (6) Congress expressed its concern with the first problem. Prior to the Act, management contracts were usually reserved for the sponsor or promoter of the investment company and his financial associates; they were drawn and executed before the distribution of securities had begun; and, in many cases, the existence of the contract never became known to the investors. Further, investors who bought securities of investment companies had been persuaded to rely on the vaunted skill and experience of the sponsor and his associates, only to have control over their funds transferred to successors they did not choose or even know. Section 15 was designed to obviate these undesirable effects by

giving investors specified rights in the selection of the initial and successor managers of their funds, and by declaring existing advisory and underwriting agreements non-assignable and automatically terminated upon their assignment.

Section 15 does not deal directly with the scope of the fiduciary obligations of those who are relinquishing management control in favor of particular successors. Nor does Section 15 deal with the widespread abuses that trafficking in the succession to these fiduciary undertakings brought in its wake. For these, the principal and effective remedy lies in the fiduciary standards developed and applied by courts of equity (pp. 12–14, *supra*) and embodied in Section 36, under which the statutory sanctions are applied against the fiduciary himself. See also Section 1 (b) (2) of the Act.

Congress did not intend that Section 15 should be read as a limitation on the broad fiduciary standards incorporated in Section 36. On the contrary, it was well understood that Section 15 was intended to affirm and amplify basic fiduciary law,[16] and to the extent that they traverse common ground Sections 15 and 36 lend reciprocal support for the policies expressed in each. In the absence of the sanctions provided under Section 36, succession to management may be put on the auction block, with the highest bidder becoming the management's choice as successor, and trading in the succession will grow in magnitude as the practice becomes commonplace, all of which can result only in undermining the fiduciary standards

[16] See Hearings before the Senate Committee on Banking and Currency on S. 3580, 76th Cong., 3d Sess. (1940), pp. 253, 505.

which Congress sought to strengthen. Through the exercise of their franchise under Section 15 investors may not approve management's choice of successor, but this seems to us an unrealistic and an ineffective means to meet the problem. Congress directed the courts to enforce fiduciary standards under Section 36, and the authority to initiate their enforcement thereunder was vested in the Commission, not the investors.

3. While this is the first case to come before the courts, the problem is of recurrent importance in the administration of the Act, and can affect each of the many investment companies registered under the Act which under common practice have investment advisory and principal underwriting agreements. The Commission in 1942 issued and released to the public an opinion of its General Counsel setting forth as Commission policy the construction of Section 36 now urged by the Commission in this case.[17] This opinion is well known to the investment company industry and has served as a guide for investment companies and their managements.[18] Many proposed transactions

[17] The General Counsel's opinion appeared as Investment Company Act Release No. 354 (R. 124–128). It is reprinted as Appendix C, *infra*, pp. 48 to 51.

[18] A pertinent illustration is an uncontested case involving Management Associates, an investment adviser for Incorporated Investors, a registered open-end company. Management Associates had outstanding 6,000 shares of stock, of which an officer held 3,000 shares. When upon his death these shares passed to his executor, it was assumed that this was a transfer of control which, as an "assignment", terminated the advisory contract. Prior to the submission of a new agreement for approval by investors, the 3,000 shares were sold to the corporation for treasury stock at net asset value. The parties and

have been abandoned or modified when, upon informal consultation, the interested parties were advised by the Commission or its staff that the proposed transactions would constitute gross abuse of trust under Section 36. The Commission's consistent interpretation of Section 36 has now been upset by the decision below. Since the Commission believes that the decision below is contrary to the policy of the Act because it fails to provide public investors with essential safeguards which Congress assured them, a definitive construction of Section 36 by this Court with respect to this basic problem is important for a proper administration of the Act.

CONCLUSION

For the foregoing reasons, it is respectfully submitted that this petition for a writ of certiorari should be granted.

J. LEE RANKIN,
Solicitor General.

THOMAS G. MEEKER,
General Counsel,
DANIEL J. MCCAULEY, Jr.,
Associate General Counsel,
AARON LEVY,
LAWRENCE M. GREENE,
Special Counsel,
Securities and Exchange Commission.

JULY 1958.

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the Commission agreed that, since the advisory arrangement with the investment company is nonassignable, no value may properly be attributed to it for the benefit of the selling stockholder or his estate. See *Incorporated Investors*, Investment Company Act Release Nos. 1911 and 1947.

APPENDIX A

Opinion of Court of Appeals

United States Court of Appeals for the Ninth Circuit

No. 15,457, Apr. 7, 1958

Securities and Exchange Commission, appellant

v.

Insurance Securities Incorporated, Trust Fund Sponsored by Insurance Securities, Incorporated, Abe P. Leach, Ossian E. Carr, Arthur J. Lonergan, Roy A. Haight, and Leland M. Kaiser, as Attorney and Proxy for Investors of Trust Fund, appellees

On Appeal from the United States District Court for the Northern District of California, Southern Division

Before Stephens, *Chief Judge,* Lemmon and Hamley, *Circuit Judges*

Hamley, *Circuit Judge:*

The sale of stock of a company which acts as investment advisor and principal underwriter of an investment company gave rise to this action. Attacking this transaction, the Securities and Exchange Commission (Commission) brought this action for injunctive relief and an accounting. Authority to bring the suit, and the jurisdiction of the district court to entertain it, were asserted under §§ 42 (e) and 44 of the Investment Company Act of 1940 (act), 15 U. S. C. A., § 80a–41 (e) and 42.

Named as defendants were Insurance Securities, Incorporated (service company), and "Trust Fund Sponsored by Insurance Securities, Incorporated," (Trust Fund). Also named as defendants were Abe P. Leach, Ossian E. Carr, Arthur J. Lonergan, Roy A. Haight (stockholders and directors of the service company), and Leland M. Kaiser, "as Attorney and Proxy for Investors of Trust Fund."

In a first cause of action, it is alleged, in effect, that defendant-directors of the service company sold a controlling interest therein to a small group of affiliated purchasers at a price greatly in excess of the net book value of the stock sold. This action, according to the amended complaint, constituted "gross misconduct" and "gross abuse of trust," within the meaning of § 36 of the act, 15 U. S. C. A., § 80a–35.

In a second cause of action, it was alleged that certain proxy solicitation materials, issued in connection with a meeting of investors called to review the service contract after this stock transaction, were false and misleading. This was asserted to be in violation of § 20 (a) of the act, 15 U. S. C. A., § 80a–20(a), and of the Commission's rules.

Defendants filed a motion to dismiss both causes of action for failure to state any claim for relief. At the same time, defendants filed nine affidavits in support of this motion and in support of, or in opposition to, other motions pertaining to temporary injunctive relief. The Commission filed counteraffidavits. After a hearing, the trial court filed an opinion stating that the motion to dismiss would be granted. An order to this effect was entered on December 4, 1956. The Commission appeals.

The action of the trial court in dismissing the suit was based solely upon a consideration of the allega-

tions of the amended complaint. The court held that the first cause of action fails to state a claim upon which relief can be granted. The reason given for reaching this conclusion was that the transaction, as described in the pleading, does not fall within the reach of § 36 of the act. It was further held that the second cause of action fails to state a claim upon which relief can be granted, because it is dependent upon a claim for relief being stated in the first cause of action.

The first and principal question presented on this appeal is whether the trial court was correct in ruling that the transaction, as alleged in the amended complaint, does not fall within the reach of § 36 of the act. Determination of this question requires us to accept, as the hypothesis for our decision, the well-pleaded facts alleged in the amended complaint. Collins v. Hardyman, 341 U. S. 651, 652. These alleged facts are set out in the immediately succeeding paragraphs of this opinion.

The service company was organized on March 9, 1938, under the laws of California. Its principal business office is located in Oakland, California. Since 1938, appellees Leach, Carr, Lonergan, and Haight have been and now are directors of that company. In addition, Leach was president of the company at the time this action was begun. Carr and Lonergan were and still are vice presidents, and Haight is secretary. All four were members of the executive committee of the company. Appellee Kaiser is a director, and, at the time the action was begun, was vice president of the company.

The service company is the sponsor, depositor, investment adviser, and principal underwriter of Trust Fund, and has no other business. Trust Fund was organized in accordance with California law under

the terms of a trust agreement dated July 1, 1938, and as subsequently amended. Trust Fund maintains its principal office in Oakland, California. It is an open-end diversified management company, within the meaning of §§ 4 and 5 of the act, 15 U. S. C. A., § 80a–4 and 5. It is registered as such with the Commission, pursuant to § 8 (b) of the act, 15 U. S. C. A., § 80a–8 (b).

Trust Fund derives its capital funds from continuous offerings to public investors of participation agreements. The net receipts are invested by Trust Fund in stocks of various insurance companies. As of December 31, 1955, net assets of Trust Fund amounted to approximately $215,000,000.

At the time this action was begun, Trust Fund had no officers or directors of its own.[1] Management functions were discharged by the service company as sponsor and investment adviser of Trust Fund.

The service company receives a "creation fee," or sales load, for the sale of participation agreements. It also receives a fee for administering Trust Fund, and management and investment supervisory fee for investment advice. The service company received fees for such services in the aggregate amounts of $2,111,777, $3,319,567, and $4,798,507 for the fiscal years ending June 30, 1953, 1954, and 1955, respectively.

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[1] As indicated in the exhibits attached to the amended complaint, however, the service company had called a meeting of the investors of Trust Fund, to be held on August 15, 1956, at which a proposed amendment of the trust agreement, creating a board of directors for Trust Fund, was to be submitted for adoption. While immaterial to the issues under consideration here, the affidavits filed in this cause indicate that the proposed amendment was adopted and put into effect on September 17, 1956.

Investors in Trust Fund have no general voting rights except in the particular circumstances specified in the trust agreement. This agreement provides, as required by the act, that Trust Fund's advisory and principal underwriting contracts must be approved annually by a vote of investors representing a majority of investment units of Trust Fund. See § 15 (a) (2) and (b) (1) of the act, 15 U. S. C. A., § 80a–15 (a) (2) and (b) (1).

The trust agreement also provides, as required by the act, that an asignment of the contract to serve as investment adviser for Trust Fund, or of the contract to serve as principal underwriter for the securities of Trust Fund, automatically terminates such contracts. See § 15 (a) (4) and (b) (2) of the act, 15 U. S. C. A., § 80a–15 (a) (4) and (b) (2).[2]

On January 1, 1956, and for some years prior thereto, the service company had outstanding 166 shares of capital stock one-hundred-dollar par value. This stock was closely held, seventy-two per cent being held, in the aggregate, by director-appellees Leach, Carr, Lonergan, and Haight. On June 29, 1956, the capital stock was split into 166,000 shares, ten-cent par value. All further reference to the capital stock of the service company will be stated in terms of number of shares outstanding after the June 29, 1956, split.

On January 1, 1956, each of the director-appellees owned 30,000 shares, or eighteen per cent, of the 166,000 shares outstanding. The balance of the stock

[2] Section 2 (a) (4) of the act, 15 U. S. C. A., § 80a–2 (a) (4), defines the term "assignment" to include

"* * * any direct or indirect transfer * * * of a contract * * * by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor."

was held by five individuals (not parties to this action) in amounts ranging from 0.6 per cent to 16 per cent of the total shares outstanding.

On February 1, 1956, the four director-appellees, either alone or in concert with others, embarked upon a plan to transfer control of the service company to a small number of purchasers affiliated among each other through stock ownership and otherwise. This was to be accomplished by selling to such purchasers a substantial part of their respective stock interests in the service company. Most of these sales were arranged through Kaiser & Co., investment bankers in San Francisco, California. Appellee Kaiser, a member of the firm, was, at the time this action was begun, a director and vice president of the service company. He was also designated as one of the attorneys and proxies for the investors at the meeting of investors called to consider proposed amendments to the trust agreement, and other matters.[3]

The total shares of the capital stock of the service company sold to the purchasers between February 1, 1956, and July 1, 1956, amounted to 88,000 shares, or fifty-three per cent of the shares outstanding. During the same period, the director-appellees sold 68,000 shares, as follows: Leach, 29,000; Carr, 13,000; Lonergan, 13,000; Haight, 13,000. The four director-appellees thus reduced their aggregate stock interest in the service company from seventy-two per cent to 31.2 per cent. The amount thereby transferred to

[3] Kaiser has since become, and still is, president of the service company. He was apparently joined as a defendant only because he was one of the proxy holders in connection with the meeting of investors referred to above. In its second cause of action, the Commission sought to enjoin the voting of these proxies. The proxies were thereafter voted when the interlocutory restraining order was dissolved.

the purchasing group amounted to about 40.8 per cent of the total outstanding. The balance of approximately thirteen per cent was purchased from the other individual holders.

The price paid for the stock was fifty dollars per share. The balance sheet of the service company shows that, as of June 30, 1956, the stockholders' equity in this company was $300,489, or $1.81 per share. The aggregate price for the total shares sold was approximately $4,240,720 in excess of their net book value. The purchase price therefore necessarily reflected the value which the service company does and will derive from the fees paid, and expected to be paid, by Trust Fund.[4]

On July 17, 1956, the service company sent to the holders of participating agreements in Trust Fund a notice of the meeting of investors to be held on August 15, 1956. Transmitted with this notice was a notice of proposed supplemental agreements with copy of the proposed supplemental trust agreement attached thereto; a proxy statement covering the matters to be dealt with at the meeting of investors; and a proxy to be signed and returned by the individual investors.

The proxy statement indicated that, in the event the proposed amendment of the trust agreement creating a board of directors for Trust Fund was adopted, it was proposed to elect, as members of that board, seven named persons who were then directors of the service company. These included appellees Leach, Kaiser, and Haight. It was indicated that these appellees

[4] It is stated in the amended complaint, as a conclusion, that the payment of twenty-five times the net asset value "represented no payment for any asset or assets owned by" the service company. The conclusion is also stated that the "value attached to said contracts (between Trust Fund and the service company) is an asset of the Trust Fund, and in law and equity is preserved for the benefit of such Trust Fund."

would also continue as members of the board of the service company, but that the other four members of the new board would resign as directors of the service company.

The proxy statement further indicated that, unless the investor specified otherwise on his proxy ballot, the units represented by such proxy would be voted in favor of the proposals referred to in the notice of meeting. This included the proposal to reinstate the investment advisory and principal underwriting contracts between the service company and Trust Fund in the then-existing form, except as affected by the creation of a board of directors of Trust Fund.[5] The three persons named as attorneys and proxies in the ballots sent to the investors were appellees Leach, Kaiser, and Haight.

The relief sought by the Commission under the first cause of action is as follows: (1) An injunction permanently enjoining the individual appellees from serving as officers and directors of the service company, and from serving as directors of the proposed board of directors of Trust Fund; (2) an injunction permanently enjoining the service company from acting as investment adviser and principal underwriter of Trust Fund; (3) an order requiring that, until final deter-

[5] These contracts, according to the Commission, had been automatically terminated, under the act, by reason of the transfer of control of the service company. It is stated in the amended complaint, as a conclusion, that:

"* * * By obtaining reinstatement and confirmation of said contracts, the purchasers of the controlling stock interest in Insurance Securities would be assured of the benefits of said contracts, for which they paid substantial sums, and the director-defendants would be assured of their inequitable profits as a consequence of the sale of such contracts.

"By reason of the foregoing, the director-defendants and Insurance Securities are guilty of 'gross misconduct' and 'gross abuse of trust' within the meaning of Section 36 of the act."

mination of the action, the amount of fees to be charged by the service company for its investment advisory and principal underwriting services in excess of actual costs or expenses thereof, be segregated and maintained in a separate account; and (4) that an accounting be rendered by director-appellees for the "inequitable and wrongful" profits realized, and to be realized, as a consequence of the sale of their stock of the service company.[6]

As before stated, the cause of action under examination is based upon the theory that the service company and its director-appellees were guilty of "gross misconduct" and "gross abuse of trust," within the meaning of § 36 of the act.[7] The trial court held that

[6] Relief sought in the form of temporary and permanent injunctions directed against the voting of proxies at the meeting of Trust Fund investors, scheduled for August 5, 1956, appears to be based upon the allegations stated in the second cause of action.

[7] Section 36 of the act reads as follows:

"The Commission is authorized to bring an action in the proper district court of the United States or United States court of any Territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after August 22, 1940, and within five years of the commencement of the action, of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts:

"(1) as officer, director, member of an advisory board, investment adviser, or depositor; or

"(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

"If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate."

this section is not applicable, because the amended complaint "makes no charge of any misconduct or abuse of trust, gross or otherwise, with respect to Trust Fund or its investors." Appellant takes issue with this conclusion of the trial court.

Appellant does not contend that every sale of a controlling interest in an investment company's investment adviser or principal underwriter necessarily constitutes "gross misconduct" or "gross abuse of trust," with respect to the investment company. It is conceded that such a sale, if made at net asset value, is proper, even though the advisory or underwriting agreement is thereby terminated under § 15 (a) (4), 15 U. S. C. A., § 80a-15 (a) (4).

Appellant argues, however, that when the sale of control of the investment adviser or principal underwriter involves receipt of consideration in excess of net asset value, "gross misconduct" or "gross abuse of trust," under § 36 is involved. The excess, it is contended, represents payment for succession to the adviser's or underwriter's fiduciary office and undertakings.[8]

It is also appellants' position that the value attached to service contracts is an asset of the investment company. The stockholders of an investment adviser having such a contract may not, according to this view, appropriate this asset to themselves by selling a controlling stock interest in the service company for a price in excess of asset value.

[8] This is undesirable, according to appellant, because it encourages the transfer of controlling interests in service companies without regard to the best interests of the investment company. The "excess value" paid in connection with such a transfer, it is argued, may also prompt the new controlling interests to pursue a hazardous or doubtful policy in an effort to recoup the purchase price.

It is for these reasons, appellant contends, that the sale of a controlling interest in a service company at a price in excess of asset value is contrary to general equitable principles. These principles, it is urged, are incorporated in § 36 of the act. Appellant argues that the facts alleged in the amended complaint disclose a transaction of this kind, and call for the relief requested.

The specific question presented by appellant's argument is whether transfer of control of an investment adviser and principal underwriter at a price in excess of net asset value constitutes "gross misconduct or gross abuse of trust in respect to" an investment company which it serves, within the meaning of § 36 of the act.[9]

The act contains no general definition of these terms nor any provision to the effect that acts of a particular kind are comprised therein. The terms, however, are obviously intended to have some meaning and application. We must therefore find it by examining the scope and content of the act as a whole, and the pertinent legislative history. As the Supreme Court has said, when terms in a statute are not exactly defined, they "derive much meaningful content from the purpose of the Act, its factual background and the statutory context in which they appear. * * *" *American Power & Light Co.* v. *Securities and Exchange Commission,* 329 U. S. 90, 104.[10]

Section 1 (b) of the act, 15 U. S. C. A., § 80a–1 (b), contains a factual recital to the effect that the na-

[9] As so framed, the question assumes, for the purposes of argument, that under the facts alleged, the control of the service company was transferred, and that this was accomplished by persons of the class specified in § 36.

[10] Our task is not to delineate the full breadth of meaning these terms may have, but only to determine whether they embrace acts of the kind here alleged.

tional public interest and the interest of investors are adversely affected when any one of eight described conditions exist. The only one of these described circumstances which is relevant to the first cause of action is that which is set out in subdivision (6) of this section."[11] This subdivision reads:

> (6) when investment companies are reorganized, become inactive, or change the character of their business, *or when the control or management thereof is transferred, without the consent of their security holders.* (Emphasis supplied.)

This provision is revelant to our present inquiry because it is here alleged, in effect, that, at the time the stock transaction took place, the service company exercised management functions with respect to

[11] Subdivision (1) relates to inadequacy or inaccuracy of information made available to investors. Subdivision (2) condemns organization, operation, or management of investment companies, or the selection of their portfolio securities, in the interests of the fiduciary instead of the security holders. As the trial court pointed out, no claim is made in the amended complaint, or otherwise, that the business of Trust Fund has not been conducted efficiently and honestly. Nor is there any claim that the investors have suffered any loss or damage with respect to their interest in Trust Fund by reason of any act or conduct described in the amended complaint.

Subdivision (3) deals with inequitable or discriminatory provisions contained in securities, and failure to protect the preferences and privileges of security holders. Subdivision (4) relates to undue concentration of control of investment companies through pyramiding or inequitable methods of control, the inequitable distribution of control of investment companies, and the management of such companies by irresponsible persons. Subdivision (5) is concerned with unsound accounting methods and inadequate auditing. Subdivision (7) is critical of excessive borrowing or other practices having the effect of unduly increasing the speculative character of junior securities. Subdivision (8) pertains to inadequate assets or reserves of investment companies.

Trust Fund. If this is so, then transfer of control of the service company operated to transfer control of the management of Trust Fund. This, according to the above-quoted statutory finding, is contrary to the public interest and the interest of investors, if accomplished without the consent of the investors. Section 1(b) concludes with a declaration that it is the policy and purpose of the act to mitigate and, so far as is feasible, to eliminate the eight enumerated conditions, including that which has been quoted.

The circumstance which is objectionable under this statutory pronouncement is transfer of control without consent, however achieved and whatever the consideration thereof. No language used in this section, or elsewhere in the act, indicates that the price paid for such a transfer of control is a circumstance to be considered.

Section 15 (a) (4) of the act gives force and effect to this statutory finding and declaration of policy. It is unlawful, under the latter provision, for a person to serve as an investment adviser except under a written contract which provides, among other things, for automatic termination of the contract in the event of its assignment by the investment adviser. Such a contract may not be renewed except by the vote of a majority of the investors.

Here again, the sanction runs against any assignment, whatever the price paid and received therefor. An assignment at net asset value is just as fruitless under this section as one for a substantial price in excess of such value. In either case, the contract is automatically terminated. In no respect is the amount paid or received for stock control made a factor to be considered.[12]

[12] Under § 15 of the act, a service contract which has been automatically terminated under paragraph (a) (4) can be re-

Appellant is thus unable to point to any statutory provision which is specifically critical of the price paid for the transfer of control of a service company. It is argued, however, that a price in excess of net asset value renders such a transfer "gross misconduct" or "gross abuse of discretion," if heed is given to historic equitable principles. In this connection, reference is made to Aldred Investment Trust v. Securities and Exchange Commission (1 Cir.), 151 F. 2d 254, 261, where it was said that § 36 "invokes the equity power of the Federal court. * * *"

Appellant then cites a number of cases which, it is urged, announce equitable principles which are applicable here. The cases relied upon and the principles announced are stated below.

It is a general principle of equity that a personal trustee cannot sell his office. *Sugden* v. *Crossland,* 65 Eng. Rep. 620; *Forbes* v. *McDonald,* 54 Cal. 98. Nor may this be done by a corporate officer or director. *Moulton* v. *Field,* 179 Fed. 673; *McClure* v. *Law,* 161 N. Y. 78, 55 N. E. 388; *Porter* v. *Healy,* 244 Pa. 427, 91 Atl. 428. A member of a class who assumes to exercise or enforce a class right may not sell it for his own profit. *Clarke* v. *Greenberg,* 296 N. Y. 146, 71 N. E. 2d 443; *Young* v. *Highbee Co.,* 324 U. S. 204. Directors of a solvent corporation may not take over for their own profit an opportunity available to the corporation. *Irving Trust Co.* v. *Deutsch* (2 Cir.), 73 F. 2d 121. A contract by the board of direc-

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instated by a vote of the investors. No exception is made in the case of an assignment in connection with which a substantial consideration was received in excess of net asset value. If this is permissible under § 15, it ought not to be subject to injunctive restraint under § 36. A practice which Congress authorized in one part of the act should not be held to be impliedly prohibited in another. *62 Cases of Jam* v. *United States,* 340 U. S. 593, 599–600.

tors of a corporation to delegate all of its powers to another corporation is unenforceable. *Sherman & Ellis* v. *Indiana Mutual Casualty Co.* (7 Cir.), 41 F. 2d 588.

The assets of a corporation may not be wasted or looted by corporate officers acting in a fiduciary capacity. *Moulton* v. *Field, supra; Bosworth* v. *Allen,* 168 N. Y. 157, 61 N. E. 163; *Gerdes* v. *Reynolds,* 28 N. Y. S. 2d 622. The president, director, and dominant stockholder of a corporation may not sell a controlling stock interest in the corporation to outsiders, where the result would be to deprive the corporation of opportunities for gain from controlling distribution to such outsiders. *Perlman* v. *Feldman* (2 Cir.), 219 F. 2d 173.

The cited cases exemplify two well-established principles of equity. One of these is that a personal trustee, corporate officer or director, or other person standing in a fiduciary relationship with another, may not sell or transfer such office for personal gain.

In our case, this equitable principle has no application. In saying this, we assume that the appellee-directors, who were the only appellees to receive remuneration from the stock transaction, occupied, with respect to Trust Fund, a fiduciary relationship similar to that involved in the above cases. We also recognize that the result of the stock transactions was to transfer control of the service company to others.

The fiduciary relationship which the service company, including its directors and leading stockholders, occupied with regard to Trust Fund arose by virtue of the service contracts. The shift in the control of the service company did not, and could not, effectuate a transfer or sale of these service contracts. Quite to the contrary, and by operation of § 15 (a) (4) of

the act, this shift in control automatically terminated the service contracts. This being the case, the price received by appellee-directors for the sale of their stock in the service company cannot be said to represent compensation for the sale or transfer of a fiduciary office involving Trust Fund.

The second principle of equity exemplified in the cited cases is that a person occupying a fiduciary relationship with another will not be permitted to exploit such relationship for personal gain, and in such manner as to deprive the other of assets to which he is entitled.

Appellant takes the position that the facts alleged in the amended complaint show that there was here a violation of that equitable principle. It is argued that the price which appellee-directors received for their stock, in excess of net asset value, represents the capitalized value of the contract between the service company and Trust Fund. This value, according to appellant, is an asset of Trust Fund. It is contended that such asset may not be appropriated by the stockholders of the service company by accepting a profit for the sale of their stock.

It is no doubt realistic to attribute a large part of the value of the service company stock to the contract which it has with Trust Fund. But this value does not represent an asset of Trust Fund. The value which the contract has for Trust Fund lies in the fact that Trust Fund receives investment, administrative, and sales service thereunder. That is all that it paid for, and appellant does not contend that Trust Fund received less.

The value which the contract has for the service company lies in the fact that it receives a profit for rendering such service for the stipulated fees. Trust

Fund contracted to pay such fees, and cannot claim any share in the profits thereunder.[13]

The price of service company stock, over and above net asset value, is based largely upon the expectation that the service contract will be renewed and profits will continue to be received. This prospect no more represents an asset of Trust Fund than do the current profits to the service company, as received. The price received by appellee-directors for their stock in the service company did not come from the coffers of the investment company, but from outside purchasers.[14]

We conclude that the general principles of equity announced in the cases cited by appellant provide no basis for attaching a "gross misconduct" or "gross abuse of trust" label to the transaction described in the amended complaint.

Nor do we find anything of consequence in the legislative history of the act which would support such a conclusion. The pertinent problem with which Congress was asked to deal was not the excess price received for the sale of a controlling interest in the stock of investment advisers.[15] Rather, it was the

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[13] Under the service contract, the service fees are not based on the number of transactions in Trust Fund, or on the amount, kinds, or values of securities bought, sold, or held by Trust Fund. No manipulation of Trust Fund investments can increase the service company's profits. The fees are based solely on what the investors pay in.

[14] Appellant has conceded that a stockholder of a service company may make a gift of the controlling stock, subject only to the automatic termination provision of § 15. This could not be true if any value in this stock in excess of net asset value belongs to Trust Fund.

[15] Neither the report of the Senate Committee on Banking and Currency on S. 4108 (Report No. 1775, 76th Cong., 3d Session) nor the report of the House Committee on Interstate and Foreign Commerce on H. R. 10065 (Report No. 2639, 76th Cong., 3d Session) comments on any problem in

transfer of control of investment advisers exercising management functions, or their assignment of the service contract to others, without the consent of the investors, regardless of the consideration received therefor. Congress recognized this problem in § 1 (b) of the act, and provided a specific remedy in § 15 (a) (4).

Section 1 (b) (6) of the act, condemning transfers of control or management of an investment company without the consent of their security holders, was originally § 2 (6) of S. 3580, 76th Cong., 3d Session. In its original form, these additional words appeared at the end of this subdivision: "* * * and without adequate public supervision."

In the final form of this subdivision, the quoted words were deleted. This indicates that Congress believed that the only remedy which was necessary with respect to this particular practice was the provision of § 15 (a) (4) for automatic termination. Appellant's brief expresses considerable doubt as to the efficacy of the remedy provided by this section. If this is a well-grounded fear, a legislative and not a judicial problem is presented. See *Bruce's Juices* v. *American Can Co.*, 330 U. S. 743, 750, 752.

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connection with the assignment of service contracts except the lack of prior knowledge or consent of investors. It was pointed out in the SEC Report on Investment Trusts and Investment Companies, Part Three (House Doc. 279, 76th Cong., 1st Session), that various inequitable practices in common use at that time added a value to management contracts far in excess of their ostensible worth. But it was the inequitable practices which constituted the evil to be dealt with. The excess worth was but a symptom of the evil. The practices there criticized are effectively dealt with in many sections of the act. The value which such contracts may have today does not result from these outlawed or regulated practices, but from the normal factors determinative of the selling price of any corporate stock.

We hold that the terms "gross misconduct" and "gross abuse of trust," as used in § 36 of the act, were not intended to embrace a transaction of the kind described in the amended complaint. It follows that the first cause of action fails to state a claim upon which relief can be granted. It is not necessary to consider the several additional reasons advanced by appellees why the trial court reached the correct result with respect to the first cause of action.

Since the second cause of action is dependent upon a claim being stated in the first cause of action, it too must fail.

Affirmed.

(Endorsed:) Opinion. Filed Apr. 7, 1958.

PAUL P. O'BRIEN,
Clerk.

Judgment

United States Court of Appeals for the Ninth Circuit

No. 15457

SECURITIES & EXCHANGE COMMISSION, APPELLANT

v.

INSURANCE SECURITIES, INC., APPELLEE

APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE NORTHERN DISTRICT OF CALIFORNIA, SOUTHERN DIVISION

This cause came to be heard on the Transcript of Record from the United States District Court for the Northern District of California, Southern Division, and was duly submitted.

On consideration whereof, it is now here ordered and adjudged by this Court, that the judgment of the said District Court in this cause be, and hereby is affirmed.

Filed and entered April 7, 1958.
A true copy.
Attest:

(S) PAUL P. O'BRIEN,
Clerk.

APPENDIX B

Pertinent provisions of the Investment Company Act of 1940, 54 Stat. 789, 15 U. S. C. 80a–1, *et seq.*, are as follows:

FINDINGS AND DECLARATION OF POLICY

SEC. 1. (a) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby found that investment companies are affected with a national public interest in that, among other things—

(1) the securities issued by such companies, which constitute a substantial part of all securities publicly offered, are distributed, purchased, paid for, exchanged, transferred, redeemed, and repurchased by use of the mails and means and instrumentalities of interstate commerce, and in the case of the numerous companies which issue redeemable securities this process of distribution and redemption is continuous;

* * * * *

(b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 30 of the Public Utility Holding Company Act of 1935, and facts otherwise disclosed and ascertained, it is hereby declared that the national public interest and the interest of investors are adversely affected—

* * * * *

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or

other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

* * * * *

(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;

* * * * *

It is hereby declared that the policy and purposes of this title, in accordance with which the provisions of this title shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

GENERAL DEFINITIONS

SEC. 2. (a) When used in this title, unless the context otherwise requires—

* * * * *

(4) "Assignment" includes any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a security holder of the assignor; but does not include an assignment of partnership interests incidental to the death or withdrawal of a minority of the members of the partnership having only a minority interest in the partnership business or to the admission to the partnership of one or more members, who, after such admission, shall be only a minority of the members and shall have only a minority interest in the business.

* * * * *

(12) "Director" means any director of a corporation or any person performing similar functions with respect to any organization, whether incorporated or unincorporated, including any natural person who is a member of a board of trustees of a management company created as a common-law trust.

* * * * *

(19) "Investment adviser" of an investment company means (A) any person (other than a bona fide officer, director, trustee, member of an advisory board, or employee of such company, as such) who pursuant to contract with such company regularly furnishes advice to such company with respect to the desirability of investing in, purchasing or selling securities or other property, or is empowered to determine what securities or other property shall be purchased or sold by such company, and (B) any other person who pursuant to contract with a person described in clause (A) regularly performs substantially all of the duties undertaken by such person described in clause (A); * * *

* * * * *

(28) "Principal underwriter" of or for any investment company other than a closed-end company, or of any security issued by such a company, means any underwriter who as principal purchases from such company, or pursuant to contract has the right (whether absolute or conditional) from time to time to purchase from such company, any such security for distribution, or who as agent for such company sells or has the right to sell any such security to a dealer or to the public or both, but does not include a dealer who purchases from such company through a principal underwriter acting as agent for such company. * * *

* * * * *

SUBCLASSIFICATION OF MANAGEMENT COMPANIES

SEC. 5. (a) For the purposes of this title, management companies are divided into open-end and closed-end companies, defined as follows:

(1) "Open-end company" means a management company which is offering for sale or has outstanding any redeemable security of which it is the issuer.

(2) "Close-end company" means any management company other than an open-end company.

* * * * *

INVESTMENT ADVISORY AND UNDERWRITING CONTRACTS

SEC. 15. (a) After one year from the effective date of this title it shall be unlawful for any person to serve or act as investment adviser of a registered investment company, except pursuant to a written contract, which contract, whether with such registered company or with an investment adviser of such registered company, unless in effect prior to March 15, 1940, has been approved by the vote of a majority of the outstanding voting securities of such registered company and—

(1) precisely describes all compensation to be paid thereunder;

(2) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company;

(3) provides, in substance, that it may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by vote of a majority of the outstanding voting securities of such company on not more than sixty days' written notice to the investment adviser; and

(4) provides, in substance, for its automatic termination in the event of its assignment by the investment adviser.

(b) After one year from the effective date of this title, it shall be unlawful for any principal underwriter for a registered open-end company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, except pursuant to a written contract with such company, which contract, unless in effect prior to March 15, 1940—

(1) shall continue in effect for a period more than two years from the date of its execution, only so long as such continuance is specifically approved at least annually by the board of directors or by vote of a majority of the outstanding voting securities of such company; and

(2) provides, in substance, for its automatic termination in the event of its assignment by such underwriter.

(c) In addition to the requirements of subsections (a) and (b) it shall be unlawful for any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, except a written agreement which was in effect prior to March 15, 1940, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved (1) by a majority of the directors who are not parties to such contract or agreement or affiliated persons of any such party, or (2) by the vote of a majority of the outstanding voting securities of such company.

(d) It shall be unlawful for any person—

(1) to serve or act as investment adviser of a registered investment company, pursuant to a written contract which was in effect prior to March 15, 1940, after March 15, 1945, or the

date of termination provided for in such contract, whichever is the prior date, or after assignment thereof subsequent to March 15, 1940, by the person acting as investment adviser thereunder; or

(2) as principal underwriter for a registered open-end investment company to offer for sale, sell, or deliver after sale any security of which such company is the issuer, pursuant to a written contract which was in effect prior to March 15, 1940, after March 15, 1945, or the date of termination provided for in such contract, whichever is the prior date, or after assignment thereof subsequent to March 15, 1940, by the person acting as principal underwriter thereunder:

* * * * *

APPENDIX C

For IMMEDIATE Release Monday, May 11, 1942

SECURITIES AND EXCHANGE COMMISSION, PHILADELPHIA

INVESTMENT COMPANY ACT OF 1940
Release No. 354

The Securities and Exchange Commission today made public an opinion of its general counsel, Chester T. Lane, to the effect that an investment adviser of a registered investment company cannot legally profit by an attempt to sell his investment advisory contract with the company.

Mr. Lane points out that under Sections 15 (a) and (d) of the Investment Company Act of 1940, investment advisory contracts with registered investment companies are not legally saleable. The opinion goes on to state that, as is recognized by the statute, a fiduciary relation exists between an investment adviser and an investment company. Consequently, the receipt of a consideration for any purported assignment of such a contract will constitute gross misconduct and gross abuse of trust, subject to Commission action under Section 36 of the Act. It is also stated that this principle applies to any situation in which an investment adviser attempts to obtain a consideration for a purported transfer to some third person of his fiduciary obligations toward the stockholders of the registered investment company, irrespective of the form of the particular transaction, the manner in which the consideration is to be received, or the source of payment.

The opinion points out that an investment adviser's position is similar to that of a trustee, officer or director and that he is under the same disability to sell his trust.

The text of the opinion is as follows:

I understand that a certain registered investment company has a contract calling for investment advisory services from A, a corporation. This contract constitutes substantially all of A's assets. X owns the controlling block of stock of A. B, a corporate investment adviser, is desirous of acting as investment adviser to the investment company. Various proposals have been made with a view toward accomplishing that result.

Under the first proposal X will transfer to B his controlling interest in A for a substantial consideration. Thereafter, a new written investment advisory contract with A, which complies with the requirements of Section 15 (a) of the Investment Company Act, will be made. As an alternative proposal it is contemplated that a contract will be entered into by A and X with B whereby A or X will receive a substantial sum in consideration of their undertaking to terminate the investment advisory contract with the investment company in order to permit B to enter into a new written contract with the investment company.

As a further alternative it is proposed that A and B will merge, the terms of the merger giving X substantial compensation in stock or cash for his interest in A. A new contract with the company resulting from the merger will be entered into by the investment company. Still another proposal is that B will merely undertake to perform the functions of investment adviser under A's contract with the investment company for its duration, while A continues to receive the compensation due thereunder with the understanding that upon

the expiration of the contract, a new contract with B will be entered into.

In each case it is intended that the new arrangement will be approved by the directors of the investment company and submitted to the stockholders of that company for approval.

You inquire whether a violation of the Investment Company Act of 1940 will be involved if any of these proposals is effected.

Section 15 (d) of the Investment Company Act in effect provides for the automatic termination of investment advisory contracts made prior to March 15, 1940, upon the assignment thereof after that date. Section 2 (a) (4) of the Act provides that the term "assignment" includes any direct or indirect transfer or hypothecation of a contract or chose in action by the assignor, or of a controlling block of the assignor's outstanding voting securities by a stockholder of the assignor. In my opinion, each of the various proposals mentioned above would involve an "assignment" within the meaning of the Act of the investment advisory contract which A has with the investment company. Consequently, by reason of Section 15 (d) of the Act, that contract would be automatically terminated upon such assignment, and no person could lawfully purport to act as investment adviser thereunder.

The legislative history of Section 15 manifests a clear Congressional intention to prevent all trafficking in investment advisory contracts and to prevent an investment adviser from transferring his fiduciary obligations by turning over the management of the stockholders' money to a different person. That intention is effectuated by the requirement in Section 15 (a) that every investment advisory contract made after March 15, 1940, must provide for its automatic

termination upon assignment. Section 15 (d) provides that contracts made before March 15, 1940, also terminate upon assignment.

Thus, Congress has said that an investment adviser cannot assign his contract and cannot transfer his fiduciary obligations. In the light of these prohibitions, and in the light of the fiduciary relationship which exists between an investment adviser and the company which he serves, it is my opinion that an investment adviser who directly or indirectly attempts to obtain a consideration for the purported transfer of his contract is guilty of gross misconduct and gross abuse of trust subject to Commission action under Section 36 of the Act. This principle applies to any situation which in substance represents an attempt by an investment adviser to profit by a purported sale of his fiduciary obligations, irrespective of the form of the particular transaction involved, the manner in which the consideration is to be received or the source of payment. In my opinion the legal status of an investment adviser is similar to that of a trustee of a trust or a director or officer of a corporation, and the investment adviser is under the same prohibitions against selling his trust.

Looking through the form of the alternative proposals which you have described to their substance, it is my view that A would in each case be guilty of gross misconduct and gross abuse of trust.

U. S. GOVERNMENT PRINTING OFFICE: 1939